DEPARTMENT OF STATE REVENUE

02-20140358.LOF

Letter of Findings Number: 02-20140358
Corporate Income Tax
For Tax Year 2009, 2010, and 2011

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.

ISSUES

I. Adjusted Gross Income Tax - Inclusion of Income.

Authority: IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1(c); I.R.C. § 351; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Monarch Beverage Co. v. Indiana Dep't of State Revenue, 589 N.E.2d 1209 (Ind. Tax Ct. 1992).

Taxpayer protests the imposition of additional adjusted gross income tax based on reallocation of income from an affiliated Subsidiary to Taxpayer.

II. Adjusted Gross Income Tax - Research Expense Tax Credit.

Authority: IC § 6-3.1-4-1 et seq.; IC § 6-3.1-4-2; IC § 6-8.1-5-1; IC § 6-8.1-5-4; I.R.C. § 41; Treas. Reg. § 1.41-4(d); Treas. Reg. § 1.6001-1; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012).

Taxpayer protests the adjustment of its claimed research expense tax credit.

III. Adjusted Gross Income Tax - Adjustment of Apportionment Factor.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012).

Taxpayer protests the use of an incorrect apportionment factor.

STATEMENT OF FACTS

Taxpayer, a corporation, is a grain processor, providing ingredients to the food, beverage, brewing, and pharmaceutical industries worldwide. Taxpayer is the parent company of affiliates filing a consolidated federal 1120 return. It has two Indianapolis locations. Taxpayer elects to file a separate Indiana income tax return based on its nexus with Indiana.

Taxpayer owns certain intangible property including trademarks, trade names, patents and proprietary know-how (referred to herein as "IP") which it created and developed. When Taxpayer incorporated Subsidiary, it transferred to Subsidiary the right to sublicense Taxpayer's IP on a non-royalty basis. In exchange for the royalty-free right to sublicense Taxpayer's IP, Subsidiary transferred to Taxpayer all of the ownership shares in Subsidiary. Subsidiary is a wholly owned subsidiary of Taxpayer.

Subsidiary sublicenses Taxpayer's IP to Taxpayer's foreign affiliates and collects royalties. The royalty income received from sublicensing the IP is then paid to Taxpayer, Subsidiary's only shareholder, in the form of dividends.

The Indiana Department of Revenue ("Department") audited Taxpayer's Indiana returns and business records for calendar years 2009, 2010, and 2011. During the audit period, Subsidiary reported minimal expenses and collected over $200 million in royalty income which it paid to Taxpayer in the form of dividends. Taxpayer reported substantial expenses, including those related to maintaining, developing, and enhancing the IP that it transferred to Subsidiary and reported large losses on its Indiana returns.

The Department concluded that Taxpayer's transfer of the IP to Subsidiary on a royalty-free basis distorted

Taxpayer's reported total income during the audit period. The Department adjusted Taxpayer's income by allocating the royalty income to Taxpayer. The Department applied Taxpayer's available net operating losses in tax years 2009 and 2010 and adjusted the claimed research expense tax credit for 2010 and 2011. The Department calculated the outstanding adjusted gross income tax liability and proposed assessments of additional adjusted gross income tax and interest for tax year 2011 only. Taxpayer protested the proposed assessment of additional adjusted gross income tax. An administrative hearing was held, and this Letter of Findings results. Additional facts will be provided as needed.

I. Adjusted Gross Income Tax - Inclusion of Income.

DISCUSSION

Taxpayer protests the proposed assessment of additional adjusted gross income tax. All tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012). The issue is whether Taxpayer met its burden to prove the assessment is incorrect.

Indiana imposes an adjusted gross income tax on "that part of the adjusted gross income derived from sources within Indiana of every corporation." IC § 6-3-2-1(b). "Income derived from sources in Indiana" is defined as "income from doing business in this state." IC § 6-3-2-2(a)(2). If a corporation's income "is derived from sources within the state of Indiana and from sources without the state of Indiana," the income apportioned to Indiana for tax purposes is calculated by multiplying the corporation's total income by an apportionment factor. IC § 6-3-2-2(b).

However, IC § 6-3-2-2(l) states, in relevant part, that

> [i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, . . . the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable . . . (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In fact, the Department shall "distribute, apportion, or allocate the income derived from sources within the state of Indiana" of related entities which are "owned or controlled directly or indirectly by the same interests" to fairly reflect a taxpayer's income derived from sources within Indiana. IC § 6-3-2-2(m).

In this case, Taxpayer is a corporation which has income that is "derived from sources within the state of Indiana and from sources without the state of Indiana . . . ." IC § 6-3-2-2(b). Therefore, Taxpayer's income apportioned to Indiana for income tax purposes is calculated by multiplying the corporation's total income by the appropriate apportionment factor. Id. However, here, the Department determined that Taxpayer's total income was distorted because of a "mismatch of expenses incurred in the development, maintenance and enhancement of the intangibles being deductible . . . while the corresponding income generated by such expenses [came] in the form of nontaxable dividends." This mismatch was accomplished through a "non-arms-length transaction[] between the Taxpayer and [Subsidiary]" in which Taxpayer transferred to Subsidiary the royalty-free right to sublicense the IP in exchange for all of the ownership shares in Subsidiary. Subsidiary reported insufficient expenses to support the maintenance, development, or enhancement of the IP, indicating that "[t]he development of the[IP] was paid for by the Taxpayer" while Subsidiary collected the royalties. During the audit period, Subsidiary collected over $200 million in royalties which it passed to its only shareholder, Taxpayer, in the form of non-taxable inter-company dividends.

Because of the resulting distortion in Taxpayer's reported total income, the Department determined that application of Indiana's allocation and apportionment provisions to Taxpayer's reported total income does not fairly represent Taxpayer's income derived from sources in Indiana. To fairly reflect the adjusted gross income as reported and correct the distortion, the Department allocated Subsidiary's royalty income to Taxpayer, which owns and controls Subsidiary. See IC § 6-3-2-2(l).

Taxpayer argues that "[t]he royalties at issue are all foreign sourced in that they are paid by [Taxpayer's] affiliated companies outside the US to compensate the US tax paying [sic] group for the use of [the IP]." Taxpayer states that the IP was not developed or deployed in Indiana during the tax years at issue and therefore the royalty income derived from licensing the IP could not be Indiana taxable income. Taxpayer cites to Letter of Findings 02-20130047 (November 27, 2013) 20140129-IR-045140003NRA.

Letter of Findings 02-20130047 addressed whether income from franchise agreements for use of intellectual property is income derived from sources in Indiana and included in the numerator of the sales factor. In this case, the Department has not asserted that the royalty income from the IP is income derived from sources in Indiana to be included in the sales factor numerator. Instead, the Department identified a distortion in the Taxpayer's reported total adjusted gross income. Reallocating the royalty income to Taxpayer, as permitted and required by IC § 6-3-2-2(l) and (m), cured the distortion.

Taxpayer next argues that the audit report's reliance on Taxpayer's profitability is misplaced. It points out that without its fiduciary expenses such as officer compensation, parent company interest, and other "presumptively additional expenses that are unique to being the publicly traded entry," Taxpayer would be profitable.

The audit report highlighted Taxpayer's lack of profitability to compare it to Subsidiary's profitability, demonstrating that Taxpayer bears the expense of maintaining and developing the IP while Subsidiary collects the royalty income from licensing the IP. The audit report notes that "[t]he development of the[IP] was paid for by the Taxpayer. The related expenses are partly the reason why Taxpayer reported net operating losses for the years 2003 to 2011." Taxpayer transferred the right to sublicense the IP on a royalty-free basis to Subsidiary but continues to bear the expense of maintaining, developing, and enhancing the IP. Taxpayer's identification of other fiduciary expenses does not correct the distortion in its reported adjusted gross income as identified in the audit report.

Taxpayer next argues that the transfer of the right to sublicense intangible property to Subsidiary was a tax-free exchange pursuant to I.R.C. § 351. Taxpayer states that the "audit report findings and conclusions do not respect the legal form of the transaction, which is a tax-free contribution of the right to sub-license [sic] the use of the technology." Taxpayer further states that "[t]he desire to ascribe taxable income to the parent company [(i.e. Taxpayer)] does not follow the legal form of the transaction."

Taxpayer's reliance on I.R.C. § 351, however, is misplaced. "Tax consequences are generally determined by the substance rather than the form of a transaction," Monarch Beverage Co. v. Indiana Dep't of State Revenue, 589 N.E.2d 1209, 1215 (Ind. Tax Ct. 1992) (citation omitted). In this case, the fact that the exchange was a tax-free exchange pursuant to I.R.C. § 351 indicates that it was not an arms-length transaction. I.R.C. § 351 permits an unincorporated entity to avoid a gain or a loss when exchanging stock for property. I.R.C. § 351 requires that, after the exchange, the person receiving stock must be in "control" of the corporation receiving property.

In this case, Taxpayer transferred the right to license its own IP to Subsidiary, an unincorporated entity, in exchange for all of Subsidiary's ownership shares. Taxpayer created and controls Subsidiary. Additionally, I.R.C. § 351 governs only the exchange of property for stock and not the resulting business relationship or income generated. Thus, I.R.C. § 351 is not relevant to a discussion of Taxpayer's protest. The fact that the exchange met the requirements of I.R.C. § 351 does not alter the audit report's conclusions.

Finally, Taxpayer argues that Subsidiary is a foreign operating corporation, and consequently "the royalty stream from [Subsidiary] cannot be attributed to [Taxpayer] and be included in the Indiana return." Taxpayer cites IC § 6-3-2-2(o), which states:

> Notwithstanding subsections (l) and (m), the department may not, under any circumstances, require that income, deductions, and credits attributable to a taxpayer and another entity be reported in a combined income tax return for any taxable year, if the other entity is:
> (1) a foreign corporation; or
> (2) a corporation that is classified as a foreign operating corporation for the taxable year by section 2.4 of this chapter.

However, the Department has not required Taxpayer, nor has Taxpayer requested, to file a combined income tax return; therefore, the provisions of IC § 6-3-2-2(o) do not apply. See also, IC § 6-3-2-2(q). Finally, even if Taxpayer filed a combined return and excluded the royalty income paid to Subsidiary as income of a foreign corporation, Taxpayer's reported adjusted gross income for Indiana income tax purposes, when reviewed by the Department, would likely be distorted. The Department would have to correct the distortion, if any, pursuant to IC § 6-3-2-2(l) and (m).

Taxpayer has not met its burden to demonstrate that the assessment was incorrect, and its protest of the assessment of additional income tax is respectfully denied.

FINDING

Taxpayer's protest of Issue I is respectfully denied.

II. Adjusted Gross Income Tax - Research Expense Tax Credit.

DISCUSSION

Taxpayer claimed a research expense tax credit for tax years 2010 and 2011. The Department adjusted the claimed research expense tax credit because the associated research project was not conducted in Indiana. Taxpayer had no adjusted gross income tax liability for 2010, so the available research expense tax credit carried forward to 2011. The Department applied the available research expense tax credit to Taxpayer's 2011 adjusted gross income tax liability, and it was exhausted.

Taxpayer protests the Department's adjustment to its claimed research expense tax credit. All tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012). The issue is whether Taxpayer met its burden to prove the assessment is incorrect.

Indiana provides for a research expense tax credit. IC § 6-3.1-4-1 et seq. "A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year." IC § 6-3.1-4-2. An "Indiana qualified research expense" is a "qualified research expense[] (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001)" which is " incurred for research conducted in Indiana." Id. (emphasis added). I.R.C. § 41 states that a "qualified research expense" may include "any wages paid or incurred to an employee for qualified services performed by such employee," "any amount paid or incurred for supplies used in the conduct of qualified research," and, subject to specific regulations, any amount paid for the right to use computers in conducting qualified research. I.R.C. § 41(b)(2). The term may also include a certain percentage of "any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research." I.R.C. § 41(b)(3). "Qualified research" is defined in I.R.C. § 41(d)(1) as "research–(A) with respect to which expenditures may be treated as expenses under section 174, (B) which is undertaken for the purpose of discovering information–(i) which is technological in nature, and (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose . . . ." The research must be for a "(i) new or improved function, (ii) performance, or (iii) reliability or quality." I.R.C. § 41(d)(3). Certain activities are specifically excluded. I.R.C. § 41(d)(4).

A taxpayer who claims a research expense tax credit "must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." Treas. Reg. § 1.41-4(d). Additionally, "any person subject to tax under subtitle A of the Code . . . shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information." Treas. Reg. § 1.6001-1 (emphasis added). For Indiana tax purposes, "[e]very person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a). Such records include "all source documents necessary to determine the tax . . . ." Id. If the Department cannot determine a taxpayer's liability and the Department reasonably believes that the taxpayer has not reported the proper amount of tax due, the Department will propose an assessment of unpaid tax based on the best information available to the Department. IC § 6-8.1-5-1(b).

In this case, the Department adjusted Taxpayer's claimed research expense tax credit because Taxpayer failed to demonstrate that the research expenses claimed for the research expense tax credit were for qualified research conducted in Indiana. Although Taxpayer stated that it "can provide support for the fact that the R&D effort was actually performed in IN (names of engineers and researchers with IN W-2s)[,]" it did not. Taxpayer has provided only additional explanations in the form of short paragraphs stating that the research was conducted in Indiana where the individuals and equipment existed to conduct the research. Taxpayer has not demonstrated that the research projects at issue met the requirements of the Indiana research expense tax credit. Therefore, Taxpayer has not met its burden to demonstrate that the assessment was incorrect. Given the totality of the circumstances, in the absence of other supporting documentation, the Department's audit properly adjusted Taxpayer's claimed Indiana research expense tax credit.

FINDING

Taxpayer's protest of Issue II is respectfully denied.

III. Adjusted Gross Income Tax - Adjustment of Apportionment Factor.

DISCUSSION

Taxpayer protests the apportionment factor used by the Department to calculate Taxpayer's income apportioned to Indiana for tax year 2011. All tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012). The issue is whether Taxpayer met its burden to prove the assessment is incorrect.

If a corporation's income "is derived from sources within the state of Indiana and from sources without the state of Indiana," the income apportioned to Indiana for tax purposes is calculated by multiplying the corporation's total income by an apportionment factor. IC § 6-3-2-2(b). For tax year 2011, it is the sales factor. IC § 6-3-2-2(b)(5). "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." IC § 6-3-2-2(e).

Taxpayer points out that "[t]he audit proposal did not allow for the additional royalty income attributed from [Subsidiary] to be included in the denominator of the apportionment factor." Taxpayer appears to be correct, and the Department will calculate the appropriate apportionment factor and the resulting Indiana income tax due.

Taxpayer met its burden to demonstrate that the apportionment factor used by the Department is incorrect, and its protest of the use of the incorrect apportionment factor is sustained.

FINDING

Taxpayer's protest is sustained on Issue III.

SUMMARY

Taxpayer's protest of on Issue I regarding the imposition of additional income tax and of Issue II the adjustment of the Indiana research expense tax credit are respectfully denied. Taxpayer's protest of Issue III regarding the use of an incorrect apportionment factor to calculate Taxpayer's 2011 adjusted gross income tax liability is sustained.

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